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In the

Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-58

G. GARVIN BROWN, III,

Petitioner,

v.

MARK PAUL FELSEN,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The opinion of the Court of Appeals (A. 50) and Findings, Conclusions and Order of the Bankruptcy Court for the District of Colorado (A. 44), are not reported. No opinion was rendered by the District Court for the District of Colorado, but an Order was entered by the District Court (A. 49) affirming the Order of the Bankruptcy Court.

JURISDICTION

The judgment of the Court of Appeals (A. 57) was entered on April 14, 1978. The petition for a writ of certiorari was filed on July 10, 1978 and was granted on October 30, 1978. The jurisdiction of this Court rests upon 28 U.S.C. § 1254(1).

STATUTES INVOLVED

84 Stat. 990 (1970)
§ 17 of the Bankruptcy Act, as amended,
11 U.S.C. § 35 – Debts Not Affected by Discharge.

The verbatim text of 11 U.S.C. § 35 is set forth in the appendix to this brief.

QUESTIONS PRESENTED

1. Whether a pre-bankruptcy state court judgment is *res judicata* on the issue of the dischargeability of the debt in bankruptcy.

2. Whether Section 17c(2) of the Bankruptcy Act confers exclusive jurisdiction on the Bankruptcy Court to determine the dischargeability of debts under Sections 17a(2) and (4) and allows the Bankruptcy Court to look behind the state court judgment.

3. Whether the Bankruptcy Court may admit and consider evidence extrinsic to the state court record in determining the dischargeability of the debt.

STATEMENT OF THE CASE

This is a suit filed in the Bankruptcy Court seeking a determination that a certain debt evidenced by a pre-bankruptcy state court judgment was not dischargeable on the basis of Section 17 of the Bankruptcy Act, as amended, 84 Stat. 990 (1970) (also referred to as 11 U.S.C. § 35). The Bankruptcy Court entered judgment for the Respondent Felsen and determined that the debt was dischargeable. The District Court for the District of Colorado and the Court of Appeals for the Tenth Circuit affirmed that determination.

In June, 1975, the Jefferson Bank & Trust ("the Bank") commenced an action against Respondent Mark Paul Felsen ("Felsen"), his company Le Mans Motors, Inc.,

and Petitioner G. Garvin Brown, III ("Brown") in the District Court in and for the County of Jefferson, State of Colorado ("the State Court Action") (A. 12).

The Bank's claims against Felsen were based on the non-payment of certain debts owed by Felsen to the Bank. (A. 12-15). The Bank's claim against Brown was based on a guaranty executed by Brown in favor of the Bank, guaranteeing payment of Felsen's indebtedness to the Bank (A. 15). Brown filed an answer to the Bank's complaint (A. 34) containing affirmative defenses to the Bank's claim and stating in pertinent part:

> 3. This Defendant [Brown] was induced to sign such guaranty by misrepresentations and nondisclosures of material facts by the other defendants [Felsen and Le Mans Motors] . . . . (A. 35).

Thereafter, Brown filed an Amended Answer with a crossclaim, which specifically incorporated by reference the Answer (A. 38). The crossclaim against Felsen was a claim for indemnity based on the guaranty.

The deposition of Felsen was taken in the State Court proceedings on October 13, 1975 (Deposition Vols. IA and IB).[1] Shortly after this deposition occurred, Felsen entered into a stipulation for the full amount claimed against him by Brown on the crossclaim in the State Court Action (A. 40) and the State Court entered judgment based on the stipulation ("the Judgment") (A.42). The State Court Judgment was based exclusively on the Stipulation. It made no determination of any issue of fact or law pertaining to the suit, nor did it specifically rule on the nature of the obligation or its dischargeability. No evidentiary record was made in the State Court.

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[1] Reference is to the Deposition of Mark Paul Felsen taken on October 13, 1975 in the State Court action which is a part of the record herein.

On January 6, 1976, Felsen filed his petition in bankruptcy (A. 1). Thereafter, Brown commenced an action in Bankruptcy Court (A. 3) pursuant to Part VII of the Bankruptcy Rules, seeking a determination that the debt owed by Felsen to Brown evidenced by the Judgment, was not dischargeable on the grounds that the debt was for money or property obtained by false pretenses within the meaning of 11 U.S.C. § 35(a)(2), and for fraud, embezzlement, misappropriation or defalcation while acting as an officer or a fiduciary within the meaning of 11 U.S.C. § (35(a) (4). Felsen anwered (A.7) and moved for summary judgment on the ground that the Judgment was *res judicata* on the issue of dischargeability, because it contained no finding of fraud on its face (A.9)

Felsen's motion for summary judgment was granted. (A. 44). The Findings, Conclusions and Order of the Bankruptcy Court makes note of the fact that fraud was raised as an issue in the State Court case and that no factual determination was made by the State Court (A. 47). The Bankruptcy Court granted the motion for summary judgment holding that, because the Judgment did not state on its face, and examination of the State Court record did not indicate conclusively, that it was based upon fraud, the debt was dischargeable. (A. 48).

The District Court affirmed the determination of the Bankruptcy Court (A. 49) as did the United States Court of Appeals for the Tenth Circuit (A. 50).

The Tenth Circuit, based on its own earlier opinion, concluded that the State Court record and Judgment are controlling in a subsequent bankruptcy proceeding and that the Bankruptcy Court must refuse the introduction of extrinsic evidence on the issue of fraud in determining dischargeability (A. 55).

SUMMARY OF ARGUMENT

The language and purpose of 11 U.S.C. § 35, as amended, make it clear that it was Congress' intent to vest exclusive jurisdiction to determine the issue of dischargeability in the Bankruptcy Courts with respect to claims for fraud, and willful and malicious conversion of property. This extended what had already been the practice under certain circumstances, to all determinations of this sort. The legislation is based on certain practical and policy considerations. Certain abuses had sprung up whereby creditors could effectively circumvent a discharge and keep certain debts alive. In addition, the Bankruptcy Act is a federal statute which in the final analysis is interpreted by the federal courts, not the state courts, and which should carry a uniform interpretation.

The Tenth Circuit interpretation merely substitutes one abuse for another, clearly not what Congress could have intended. It forces creditors to raise superfluous issues in state court proceedings because of the possibility of a bankruptcy in the future. This ties up the courts' time with issues which may never become relevant, or only at a later time in a later proceeding.

Because the Bankruptcy Court cannot go behind the State Court record under the Tenth Circuit rule, it leaves the adjudication of dischargeability essentially with the states, not the Bankruptcy Court as Congress intended. However, some state courts have made clear that they will not determine that issue, leaving the creditor with no court in which he can be heard on the issue of dischargeability. Even if a debtor is successful in having the fraud claim and its dischargeability determined in a state court, if these issues are collateral in rendering the judgment, they still may not be binding on the debtor and the matter can be relitigated, causing two hearings on these issues, where only one is necessary.

Both the law and sound judicial administration require that a Bankruptcy Court be the arbiter of dischargeability and conduct its own hearing in order to do so.

ARGUMENT

THE BANKRUPTCY COURT HAS EXCLUSIVE JURISDICTION TO DETERMINE DISCHARGEABILITY OF CERTAIN DEBTS, AND SHOULD CONSIDER EVIDENCE EXTRINSIC TO THE STATE COURT RECORD IN MAKING ITS DETERMINATION.

A. The Bankruptcy Act Vests the Bankruptcy Court with the Exclusive Jurisdiction to Determine the Issue of Dischargeability with Respect to Claims for Fraud and Willful and Malicious Conversion of Property.

The exclusive jurisdiction of the Bankruptcy Court over the issue of dischargeability was made clear in 1970 when Congress amended Section 17 of the Bankruptcy Act to provide a procedure in the Bankruptcy Court by which a bankrupt or a creditor can have the dischargeability of a debt determined.[2] It specifically states in Subsection (c)(3) that the Bankruptcy Court "shall determine the dischargeability of any debt for which an application for such determination has been filed . . .", and in Subsection (c)(2) that with regard to debts not dischargeable under Subsections (a) (2), (4) or (8), if a creditor seeks a determination of nondischargeability he *must* file his application in the Bankruptcy Court. The language is mandatory and effectuates the expressed purpose of the statute to make the Bankruptcy Courts the exclusive arbiters of the issue of dischargeability.

Both the House and Senate advised[3] that the new law makes clear beyond peradventure that the Bankruptcy

[2] The Bankruptcy Reform Act, P.L. 95-598 (1978), contains essentially the same provision in Section 523.

[3] S. Rep. No. 91-1173, 91st Cong., 2d Sess. (1970); H.R. Rep. No. 91-1502, 91st Cong., 2d Sess. (1970).

Courts will have exclusive jurisdiction to determine dischargeability with respect to claims for fraud and willful and malicious conversion of property:

> Under it, the matter of dischargeability of the types of debts commonly giving rise to the problem; that it, those allegedly incurred as a result of loans based upon false financial statements, will be within the exclusive jurisdiction of the bankruptcy court. S. Rep. No. 91-1173 at 2; H.R. Rep. No. 91-1502 at 2.

The statutory change was prompted by the practical problems which had arisen in the administration of the Bankruptcy Act with regard to the discharge of debts.

One of the problems was the potential and actual abuse of the current procedure by creditors. Prior to the 1970 Amendments, the determination of the dischargeability of a debt was a two-pronged process. The Bankruptcy Court determined whether a discharge should be granted, and another court, either state or federal district court, determined the effect of the discharge on the particular claim or debt. After a bankrupt received his discharge, a creditor would sue in state court alleging fraud or similar claims. The debtor, relying on the discharge in bankruptcy, might ignore the State Court proceeding. However, because discharge of the debt in bankruptcy was an affirmative defense, failure to respond to the state court action and plead the discharge would lead to judgment for the creditor. Thus, the creditor would obtain a default judgment on the basis of fraud, a non-dischargeable obligation.[4]

Even prior to the 1970 Amendment, the Bankruptcy Court could under unusual circumstances hear the case and

[4] Memorandum of the National Bankruptcy Conference of January 21, 1970, to the Senate Judiciary Committee, reproduced in S. Rep. No. 91-1173 at 7, and in the record of House deliberations, 116 Cong. Rec. H. 9550 (Oct. 5, 1970); Countryman, *The New Dischargebility Law*, 45 Bank, L.J. 1 (1970).

review the dischargeability of a specific debt. In doing so, it could even hear evidence extrinsic to the existing record. *Local Loan Co. v. Hunt,* 292 U.S. 234 (1934); *Martin v. Rosenbaum,* 329 F. 2d 817 (9th Cir. 1964); *In re Johnson,* 323 F. 2d 574 (3d Cir. 1963); *Greenfield v. Tuccillo,* 129 F. 2d 854 (2d Cir. 1942). This exception was apparently invoked when the courts determined that the debtor was being abused and fairness dictated a review of the state judgment.

The abuse was cured by vesting in the Bankruptcy Court the power to determine the dischargeability of the debt, and to provide the debtor with a meaningful opportunity to be heard on the issue. As the National Bankruptcy Conference advised, the investiture of exclusive jurisdiction in the Bankruptcy Court merely extended, and made routinely available to debtors and creditors, review of the issue of dischargeability. The judicial remedy was adopted as a statutory one.

A second factor behind the legislation is the federal nature of the Bankruptcy Act. The Bankruptcy Act is a federal statute which should carry a uniform interpretation throughout the country. In ruling on issues, such as dischargeability, the Bankruptcy Court is applying federal law and is not bound by the state law. Lee, *Case Comment,* 50 Am. Bankr. L. J. 175 (1976).

> [I]n the last analysis, it is the U.S. Supreme Court which has ultimate word on the construction of Section 17 of the Bankruptcy Act . . . . Since this is a Federal Statute, the Federal courts necessarily have the final word as to the meaning of any terms contained therein.[5]

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[5] Letter of Royal E. Jackson, Chief, Division of Bankruptcy of September 15, 1970, to the Chairman, Senate Committee on the Judiciary, reproduced in S. Rep. 91-1173, at 6.

Thus, whether or not a particular debt is dischargeable because of fraud, false pretense or malicious and willful acts of the bankrupt is a matter of federal law, specifically turned over to the Bankruptcy Courts for interpretation.

B. The Purpose of the Bankruptcy Act and Sound Judicial Administration Dictate that the Bankruptcy Courts Hear Evidence Dehors the State Court Record in Determining Dischargeability.

The purpose and goals of 11U.S.C. § 35 can only be accomplished if the Bankruptcy Court can hear and consider evidence concerning the nature of debt, which may be *dehors* the state court record. *In re McMillan,* 579 F. 2d 289 (3d Cir. 1978); *In re Houtman,* 568 F. 2d 651 (9th Cir. 1978); *In re Pigge,* 539 F. 2d 369 (4th Cir. 1976); *See also, Fierman v. Lazarus,* 361 F. Supp. 477 (E. D. Pa. 1973), *aff'd,* 493 F.2d 1400 (3d Cir. 1974); *In re Burns,* 357 F. Supp. 176 (D. Kan. 1972).

The interpretation of the Tenth Circuit in this case and in *In re Nicholas,* 510 F. 2d 160 (10th Cir.), *cert. denied,* 421 U.S. 1012 (1975) appears to ignore the express language and purpose of the Amendments in 1970, allowing the state courts to determine whether the debt is dischargeable. This is contrary to the law as expressed in 11 U.S.C. § 35.

The Tenth Circuit's opinion in this case reflects a policy determination that has broad ramificiations for all holders of commercial paper, such as notes or guaranties, pursuing their claims against potential bankrupts. The interpretation of 11 U.S.C. § 35 adopted by the Tenth Circuit forces a creditor, while pursuing his claim in state court, to anticipate the debtor's bankruptcy and to make certain that every judgment arising from a state court proceeding rests squarely on fraud, rather than on breach of contract. In order to protect himself, the creditor must commit the very abuse Congress intended to cure, namely seek a default or

litigated judgment making certain that its based primarily on the ground of fraud.

This reduces the incentive of a commercial creditor to settle a case and stipulate judgment because that judgment may omit the crucial rulings on fraud. It forces the creditor to proceed on, and forces the court to try, issues of fraud because of the possibility of a future bankruptcy. Thus, even though a claim for breach of contract is uncontested, the parties must proceed on a superfluous claim of fraud in order to protect against a discharge. The result is to place an additional burden on the courts' already overcrowded dockets. Even though only a small fraction of claims will end up in bankruptcy, in order to protect himself, a creditor must in each case raise all issues of fraud and dischargeability.

The issue was addressed by the Third Circuit in *In re McMillan, supra.* That Court recognized the practical administrative problem inherent in such a situation:

> The defendant in a suit should not be compelled, at his peril, to embark on extensive litigation involving perhaps some minor matters in order to prevent the operation of a judgment which would be held conclusively to have established against him every material fact alleged and not denied in the declaration, so as to preclude him from showing the truth if another controversy should arise between the same parties. 579 F. 2d at 293.

Under the Tenth Circuit interpretation, the question of dischargeability in actuality will be determined by the state. The nature of the indebtedness is the critical determination for purposes of dischargeability and the Tenth Circuit rule transfers that determination to the State court, leaving to the bankruptcy court merely the formal application of 11 U.S.C. §35. Consequently, the Tenth Circuit

treats the failure of the state court to enter judgment on nondischargeable grounds as a bar to the creditor pursuing nondischargeability in bankruptcy court, even though the particular facts pertaining to 11 U.S.C. §§ 35 (a)(2) or (4) may not be raised in the state court because they would not be necessary to obtaining judgment on commercial instruments. Such facts become relevant only after a bankruptcy is pending and only on the issue of dischargeability. Such facts have no bearing on whether or not one party is indebted to another and the state court is not directly focusing on the issue of dischargeability. The 1970 Amendment to Section 17 was designed to cure certain abuses by creditors. The Tenth Circuit approach merely creates an opportunity for abuse by the debtors, and provides a judicially sanctioned means of circumventing the statute. A wily debtor need only default or agree to a judgment in state court on any ground but fraud, then rush into bankruptcy.

An additional consideration was focused on in *McMillan.* Essential to the applicability of the doctrine of *res judicata* is that the issue have been actually litigated. A default judgment, or stipulated judgment, involves no determination by the finder of fact and provides no real guidance on the merits of the case to courts which may later have cause to consider the judgment. Similarly, if a contract and a fraud claim are pleaded, it is generally unnecessary for the court to even consider the fraud claim in rendering judgment. *In re Pigge, supra.* Thus, even if a creditor frames his case in anticipation of bankruptcy, it is not clear that he can avoid duplicate hearings in many cases, adding to the burden of the courts. If two claims, contract and fraud, are raised, and judgment entered on both, the creditor may still not be able to rely on the judgment. If an issue, such as the fraud issue, is not necessary to the rendition of the judgment, but was merely collateral, a prior judgment will not foreclose consideration of the same issue again. *Halpern v. Schwartz,* 426 F. 2d 102, 105 (2d Cir. 1970).

The facts and issues peculiar to 11 U.S.C. § 35 should not be raised in a state court proceeding because dischargeability is not at that time in issue. The doctrine of *res judicata* is therefore not applicable. Even if a creditor attempted to present the issue to the state court, the state courts, at least in the Tenth Circuit, are unwilling to take up these additional claims. Schwartz v. Blue, ... Colo. App. ..., 573 P. 2d 941 (1977); *Kuzemchak v. Pitchford,* 81 N.M. 438, 468 P 2d 409, *cert. denied,* 400 U.S. 833 (1970).

The state court will not determine whether a particular debt is nondischargeable because of fraud, false pretenses or malicious and willful acts of the bankrupt and the Tenth Circuit has stated that Bankruptcy Courts cannot make such a determination independent from the state court record. A creditor is effectively denied an opportunity to have the true nature of the obligation determined. One abuse has been substituted for another.

Both the law and sound judicial administration require that the Bankruptcy Court be the arbiter of dischargeability of a debt evidenced by a pre-bankruptcy judgment and conduct its own hearing in order to do so. Failure to allow a Bankruptcy Court to admit and consider evidence effectively makes the state courts the final adjudicators of this issue, contrary to 11 U.S.C. §35 and its expressed purpose.

CONCLUSION

The judgment of the Court of Appeals affirming the order granting summary judgment should be reversed, and Petitioner should be allowed to proceed on his Complaint to Determine Dischargeability in the Bankruptcy Court.

Respectfully submiited,

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APPENDIX

35. *Dischargeability of debts—Debts not affected by a discharge.* (a) A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether allowable in full or in part, except such as (1) are taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof within three years preceding bankruptcy: Provided, however, That a discharge in bankruptcy shall not release a bankrupt from any taxes (a) which were not assessed in any case in which the bankrupt failed to make a return required by law, (b) which were assessed within one year preceding bankruptcy in any case in which the bankrupt failed to make a return required by law, (c) which were not reported on a return made by the bankrupt and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt, (d) with respect to which the bankrupt made a false or fradulent return, or willfully attempted in any manner to evade or defeat, or (e) which the bankrupt has collected or withheld from others as required by the laws of the United States or any State or political subdivision thereof, but has not paid over; but a discharge shall not be a bar to any remedies available under applicable law to the United States or to any State or any subdivision thereof, against the exemption of the bankrupt allowed by law and duly set apart to him under this title: *And provided further,* That a discharge in bankruptcy shall not release or affect any tax lien; (2) are liabilities for obtaining money or property by false pretenses or false representations, or for obtaining money or property on credit or obtaining an extension or renewal of credit in reliance upon a materially false statement in writing respecting his financial condition made or published or caused to be made or published in any manner whatsoever with intent to deceive, or for willful and malicious conversion of the

property of another; (3) have not been duly scheduled in time for proof and allowance, with the name of the creditor, if known to the bankrupt, unless such creditor had notice or actual knowledge of the proceedings in bankruptcy; (4) were created by his fraud, embezzlement, misappropriation or defalcation while acting as an officer or in any fiduciary capacity; (5) are for wages and commissions to the extent they are entitled to priority under subdivision (a) of section 104 of this title; (6) are due for moneys of an employee received or retained by his employer to secure the faithful performance by such employee of the terms of a contract of employment; (7) are for alimony due or to become due, or for maintenance or support of wife or child, or for seduction of an unmarried female, or for breach of promise of marriage accompanied by seduction, or for criminal conversation; or (8) are liabilities for willful and malicious injuries to the person or property of another other than conversion as excepted under clause (2) of this subsdivision.

(b) The failure of a bankrupt or debtor to obtain a discharge in a prior proceeding under this title for any of the following reasons shall not bar the release by discharge in a subsequent proceeding under the title of debts that were dischargeable under subdivision (a) of this section in the prior proceeding: (1) discharge was denied in the prior proceeding solely under clause (5) or clause (8) of subdivision (c) of section 32 of this title; (2) the prior proceeding was dismissed without prejudice for failure to pay filing fees or to secure costs. If a bankrupt or debtor fails to obtain a discharge in a proceeding under this title by reason of a waiver filed pursuant to section 32(a) of this title or by reason of a denial on any ground under section 32(c) of this title other than clause (5) or clause (8) thereof, the debts provable in such proceeding shall not be released by a discharge granted in any subsequent proceeding under this title. A debt not released by a discharge in a proceeding under this title by reason of clause (3) of sub-

division (a) of this section may nevertheless be dischargeable in a subsequent bankruptcy proceeding.

(c) (1) The bankrupt or any creditor may file an application with the court for the determination of the dischargeability of any debt.

(2) A creditor who contends that his debt is not discharged under clause (2), (4), or (8) of subdivision (a) of this section must file an application for a determination of dischargeability within the time fixed by the court pursuant to paragraph (1) of subdivision (b) of section 32 of this title and, unless an application is timely filed, the debt shall be discharged. Notwithstanding the preceding sentence, no application need be filed for a debt excepted by clause (8) if a right to trial by jury exists and any party to a pending action on such debt has timely demanded a trial by jury or if either the bankrupt or a creditor submits a signed statement of an intention to do so.

(3) After hearing upon notice, the court shall determine the dischargeability of any debt for which an application for such determination has been filed, shall make such orders as are necessary to protect or effectuate a determination that any debt is dischargeable and, if any debt is determined to be nondischargeable, shall determine the remaining issues, render judgment, and make all orders necessary for the enforcement thereof. A creditor who files such application does not submit himself to the jurisdiction of the court for any purposes other than those specified in this subdivision (c).

(4) The provisions of this subdivision (c) shall appply whether or not an action on a debt is then pending in another court and any party may be enjoined from instituting or continuing such action prior to or during the pendency of a proceeding to determine its dischargeability under this subdivision.

(5) Nothing in this subdivision shall be deemed to affect the right of any party, upon timely demand, to a trial by jury where such right exists.

(6) If a bankruptcy case is reopened for the purpose of obtaining the orders and judgments authorized by this subdivision no additional filing fee shall be required.